No. 21104

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA, APPELLANT

v.

HASKEL ENGINEERING & SUPPLY CO., APPELLEE

BRIEF FOR THE APPELLEE

GOODSON AND HANNAM
WALTER S. WEISS
RICHARD W. CRAIGO

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Miscellaneous:

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On Appeal From the Judgment of the United States District Court for the Southern (Now Central) District of California

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BRIEF FOR THE APPELLEE

QUESTIONS PRESENTED

1. Whether the District Court erred in finding that appellee's Series A Debenture Bonds were evidences of indebtedness within the meaning of the Internal Revenue Code.

2. Whether the District Court erred in finding that interest payments made with respect to appellee's Series A Debenture Bonds constituted a deductible expense under the Internal Revenue Code.

3. Whether the District Court erred in finding that redemption premium payments made with respect to appellee's Series A Debenture Bonds constituted a deductible expense under the Internal Revenue Code.

4. Whether the District Court erred in finding that appellee's annual additions to its bad debt reserves

were reasonable and therefore deductible under the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

In addition to the Statutes and Regulations set forth in appellant's brief, the following Regulation is involved:

Treasury Regulation on Income Tax (1954 Code):

Sec. 1.61-12(c) Sale and purchase by corporation of its bonds.

"(1) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. . ."

STATEMENT OF THE CASE

Debenture Bond Issue

In June, 1952, appellee, HASKEL ENGINEERING & SUPPLY CO., was duly incorporated under the laws of the State of California to engage in the design, development and sale of hydraulic parts and equipment. At the same time, HASKEL ENGINEERING & SUPPLY CO., a partnership comprised of Richard L. Hayman and Donald W. Driskel, made a bona fide offer to transfer to appellee solely in exchange for 1500 shares of appellee's no par value voting common stock, the following partnership assets having the

following values:

	Value
Leasehold Improvements	$ 3,377.38
Furniture and Fixtures	699.54
Equipment	1,757.08
Automobiles	1,187.04
Good Will	14,000.00
Prepaid Rent	1,360.00
Prepaid Insurance	195.47
Prepaid Office Expenses	164.50
Deposits	27.75
TOTAL	$22,738.76 (I-R.214,Exh.10)[1]

The good will referred to above included (1) customer lists and accounts; (2) substantial unfilled orders; (3) the name "HASKEL ENGINEERING & SUPPLY CO."; and (4) "going concern value" as represented by an established, integrated, profitable business structure with organized plant facilities and experienced personnel. (I-R. 214-215)

At the same time, said partnership made a further bona fide offer to transfer to appellee, solely in exchange for $64,000.00 of Series A Registered Debenture

[1] "I-R." and "II-R." references are to Volumes I and II of the record on appeal. "Tr." references are to the reporter's transcript of the January 24, 1966 proceedings in the Court below. "Br." references are to the appellant's brief. "Exh." refers to exhibit admitted in evidence.

Bonds of appellee, the following partnership assets having the following value:

	Value
Inventories	$30,595.55
Accounts Receivable	28,232.24
Furniture and Fixtures	5,172.21
TOTAL	$64,000.00 (I-R. 125, Exh. 9)

The Board of Directors of appellee, by appropriate resolution, accepted the aforementioned offers of HASKEL ENGINEERING & SUPPLY CO. partnership. (Exh. 8) An application was duly filed with the Commissioner of Corporations of the State of California for a permit authorizing appellee to sell and issue the aforesaid capital stock and Debenture Bonds. (Exh.11) In August, 1952, a permit for such issuance was duly granted by the Commissioner of Corporations. (Exh. 12) Thereupon, in accordance with said permit, appellee issued the capital stock and Debenture Bonds in exchange for the assets set forth above. (I-R. 215) Each Debenture Bond was in the face amount of $1,000.00 and provided for: (1) A fixed maturity date of June 4, 1972; (2) Interest at the rate of four (4%) percent per annum payable until maturity; (3) Acceleration of the indebtedness upon default; (4) A redemption premium of two (2%) percent of the face amount for each year that maturity was accelerated, such redemption to occur only after June 5, 1954. (I-R. 216, Exh. 13)

With regard to the terms of said Debenture Bonds,

it was the unequivocal intention of both appellee and the bondholders that a true debtor-creditor relationship be established. The bondholders were unwilling to subject all of their investment in appellee to the permanent risk of appellee's business. (II-R. 79-80) Accordingly, they concluded that a portion of their total investment should be represented by debt instruments enabling them to share with other creditors in the event appellee encountered future financial difficulties. Furthermore, the bondholders desired to protect their respective heirs by assuring said heirs a fixed flow of income in the event of their untimely deaths. (II-R. 80) The redemption premium payment feature was intended to protect the heirs of the bondholders by increasing the marketability of the bonds. (II-R. 83-85)

During each of the years 1952 through 1958, appellee regularly paid to the holders of the Debenture Bonds four (4%) percent interest on the face amount thereof. (This amount wasin excess of the rate then being paid by California savings and loan associations). No interest payments were ever omitted during these years and the amounts paid were always exactly as required by the terms of said Debenture Bonds. The interest payments were in no way contingent upon earnings of appellee. Debenture Bonds were never subordinated to any other debts of appellee at any time. Debenture Bonds were

always clearly reflected on appellee's books, records and financial statements and in Dun and Bradstreet credit reports, as outstanding long-term indebtedness. (I-R. 216-217, II-R. 88-89, Exh. 29)

As a result of unexpected and substantial business profits, appellee was in a favorable cash position during its taxable year 1957. Since the large long-term debt being carried on its financial statements had caused some concern among its customers in the past, (II-R 88-92) appellee's Board of Directors decided to redeem approximately one-half of the Debenture Bonds outstanding. This decision was also based upon their determination that such redemption would reduce future interest payments and would result in a tax deduction during a high-profit period. (II-R. 92) Accordingly, the redemption was effected. In appellee's taxable year 1958, the Board of Directors, for essentially the same reasons, effected a redemption of the remaining Debenture Bonds. (I-R. 217)

During the taxable years 1957 and 1958, interest payments were made by appellee with respect to its Debenture Bonds in the amounts of $2,599.92 and $2,053.26, respectively. During the taxable years 1957 and 1958 appellee made redemption premium payments in the amounts of $9,600.00 and $10,500.00, respectively. On its tax returns for these taxable years, appellee duly claimed

deductions for these payments. (I-R. 125) The Commissioner determined deficiencies based upon a disallowance of all of the interest and redemption premium payments. (I-R. 127)

The District Court found that the Debenture Bonds were precisely what they purported to be - evidences of indebtedness within the meaning of the Internal Revenue Code - and allowed appellee's claimed deductions. (I-R. 219)

Reserve for Bad Debts Issue

Since its inception, appellee employed the reserve method of accounting for bad debts. (II-R. 217-218) At the end of each of the taxable years 1958 and 1959, appellee segregated and listed all accounts receivable by age and then undertook a detailed review of all delinquent accounts with appellee's credit manager, considering both past history and future probability of anticipated losses. (II-R. 37-39, 93-96) On the basis of this extensive review, appellee determined a reasonable annual addition to its bad debt reserve. In each year involved the reserve, after allowance for bad debts incurred during the taxable year, amounted to approximately two (2%) percent of appellee's total accounts receivable. Among the facts at the end of each year which were considered was the fact that smaller accounts were being added, thus increasing the probability that increased losses would be incurred. (II-R. 37-42) This method of

annual review of accounts receivable was found by the District Court to be in accordance with sound business judgment and accepted accounting principles. (I-R. 218) Deductions for the additions to the reserve were duly claimed for each of the taxable years.

The Commissioner determined that reasonable additions to appellee's bad debt reserves for the years in question should have been determined solely from a simple mathematical calculation based upon appellee's past history of losses even though its total accounts receivable had risen from approximately $32,000.00 to $321,000.00. On the basis of this calculation, the Commissioner determined that no additions should have been made for 1958, (in lieu of appellee's addition of $3,130.80) and that $917.25 was a proper addition for 1959 (in lieu of appellee's addition of $1,800.00). (I-R 126-127)

The District Court found that appellee having used sound business methods and standard accounting practices, had established that its additions to bad debt reserve was reasonable. (I-R. 218)

SUMMARY OF ARGUMENT

The questions on appeal concern the propriety of the District Court's findings and conclusions with regard to certain deductions taken by appellee in connection with interest and redemption premium payments

made with respect to its Registered Debenture Bonds during taxable years 1957 and 1958, and in connection with additions to its bad debt reserves during taxable years 1958 and 1959. Appellant insists that the District Court applied incorrect standards in considering both of these questions and that its conclusions were clearly erroneous. Appellee submits that the District Court's findings of fact were supported by substantial and overwhelming evidence and that the District Court applied correct standards in concluding that appellee was entitled to each of its claimed deductions.

The Interest and Redemption Premium Payments

The primary question is whether appellee's Debenture Bonds constituted "indebtedness" within the meaning of the Internal Revenue Code, or whether they should rather be considered as part of the shareholders' capital investments in appellee.

In determining this question, the courts have looked first to whether the evidences of indebtedness are enforceable under local law. The courts then look to a wide array of factual criteria to determine whether such debt should be treated as indebtedness for purposes of taxation. The District Court here found not only that the Debenture Bonds constituted valid indebtedness for purposes of local law, a finding unchallenged by appellant, but thereafter made specific findings of fact that the Debenture Bonds satisfied

almost every single criterion used by the courts. On this basis, the District Court concluded that as a matter of law, the Debenture Bonds constituted indebtedness within the meaning of the Internal Revenue Code.

Among the findings and uncontroverted testimony upon which the District Court's findings were based were the facts that (1) the Debenture Bonds had a fixed maturity date; (2) they contained an unconditional promise to pay in all events which was in no way dependent upon or was related to the earnings of appellee; (3) upon default the entire principal amount of the Debenture Bonds was due and payable; (4) there were no provisions for any participation by the bondholders in the management of appellee; (5) the Debenture Bonds were never subordinated to the claims of other creditors; (6) it was the intention of the parties to create a debtor-creditor relationship; (7) the Debenture Bonds were always clearly reflected on appellee's books, records and financial statements as long-term debt; (8) appellee was adequately capitalized, i.e., there was no "thin" capitalization; and (9) payments of interest were always timely made and no such payments were ever omitted. The courts have held almost universally that satisfying these criteria qualifies the debt as an "indebtedness" for purposes of the Internal Revenue Code.

In opposition to this evidence, appellant

argues that the Debenture Bonds were not debt for tax purposes since appellant contends the Debenture Bonds were not marketable in the sense that a hypothetical third party would not have invested in them. Appellant's entire argument is in the form of a philosophical discussion totally lacking in recognized precedent and authorities which ignores all other relevant criteria (especially the criteria of intent and adequate capitalization) and places all-pervasive importance on claimed lack of marketability, which appellant fails to establish. In view of the overwhelming factual proofs, appellee submits that the findings of the District Court were not clearly erroneous and that Debenture Bonds constituted valid indebtedness within the meaning of the Internal Revenue Code.

Appellant raises improperly for the first time on appeal, an issue that even if the bonds constitute indebtedness for federal tax purposes, payments of the redemption premiums thereon are not deductible as either interest or business expenses. Appellant cites no authority for this proposition. Since the redemption premiums were regularly made on valid debt instruments they are clearly deductible.

Finally, appellant uses questionable candor in claiming that the District Court erred in its application of a legal standard. Appellant claims that the District Court merely found that the debt was enforceable under

state law and that since there was no showing of "fraud" against the United States, that appellee should prevail. The record clearly establishes that the Court did apply the proper standards.

The Additions to Appellee's Bad Debt Reserve

The amounts in question here are de minimus. Appellee made additions to its bad debt reserve raising its total reserve to approximately two (2%) percent of total accounts' receivable. Although minimal, the additions were made in accordance with a meticulous, thorough and acceptable business and accounting procedure, whereby all accounts were listed and segregated by age and individually reviewed as to collectable status based upon both past history and future probability and the changing nature of appellee's customers.

Appellant did not refute any of this testimony. but contends that the application of a simple inflexible mathematical formula based solely upon past history is the exercise of sound discretion.

Appellant argues that this simple mathematical determination is not subject to attack. Appellee, on the other hand, contends that the Commissioner not only abused its discretion but employed no discretion whatever.

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ARGUMENT

I

The District Court Correctly Determined That Appellee Was Entitled To Deductions In The Years Involved For The Interest And Redemption Premium Payments Made With Respect To Its Series A Four Percent Registered Debenture Bonds.

Appellee claimed deductions for payments of interest on its Debenture Bonds in the amounts of $2,599.92 and $2,053.26, respectively, and for payments of redemption premiums on its Debenture Bonds in the amounts of $9,600.00 and $10,500.00, respectively, for its taxable years 1957 and 1958. The District Court concluded that the Debenture Bonds were precisely what they purported to be and that appellee had properly claimed all of these deductions.

A. The Debenture Bonds Constituted Indebtedness Within the Meaning of the Internal Revenue Code.

The question on appeal is whether the District Court erred in holding that appellee was entitled to deductions for the payments to its bondholders with respect to its Debenture Bonds. Appellant contends that in substance the Debenture Bonds constituted part of the capital investment in appellee. Implicit in the determination of this issue is the extent to which the shareholders of a close corporation are free to allocate

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their investment between debt and equity.[2] This is a question of fact and under familiar principles the findings of the Trial Court are conclusive unless clearly erroneous, the critical determination being whether there is any substantial evidence to support the conclusion reached by the trier of fact. Wilbur Security Co. v. Commissioner,[3] 279 F.2d 657, 659 (9th Cir. 1960).

Appellee submits that there is substantial evidence supporting the District Court's finding of fact and conclusion of law that appellee's Debenture Bonds were evidences of indebtedness within the meaning of section 163(a) of the Internal Revenue Code. (I-R. 216, 219)

In approaching this factual determination, the Second Circuit Court of Appeals has stated that such is a two-step process; first, whether the evidence of indebtedness did, in fact, create a debt, and second, if so,

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[2] It has been well settled for many years that a closely held corporation possesses an independent tax status, and real transactions, even though designed to procure a tax advantage, will not be disregarded. Samson Tire v. Rogan, 136 F.2d 345 (9th Cir. 1943); Commissioner v. Laughton, 113 F.2d 103 (9th Cir. 1940).

[3] In Taft v. Commissioner, 314 F.2d 620, 622 (9th Cir. 1963) it was stated that this might present a mixed question of law and fact.

should such debt be treated as "indebtedness" for purposes of federal taxation. Nassau Lens Co. v. Commissioner, 308 F.2d 39, 46 (2nd Cir. 1962).

Regarding the first question, it is clear that the Debenture Bonds created valid indebtedness for purposes of local law, having been duly authorized for issuance by the California Corporations Commissioner. (II-R. 215)[4] Appellant has not seriously disputed this fact.

On the second question, courts have looked to various factual criteria for the purpose of making a determination of whether the indebtedness should be treated as debt for purposes of federal taxation. See Taft v. Commissioner, supra; Los Angeles Shipbuilding & Drydock Corp. v. United States, 289 F.2d 222 (9th Cir. 1961); Wilbur Security Co. v. Commissioner, supra; O. H. Kruse Grain and Milling v. Commissioner, 279 F.2d 123 (9th Cir. 1960); Earle v. W. J. Jones & Son, Inc., 200 F.2d 846 (9th Cir. 1952); Wilshire and Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718 (9th Cir. 1949); Maloney v. Spencer, 172 F. 2d 638 (9th Cir.

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[4] Even Mr. Ricks, a witness for appellant testified under cross-examination that in his opinion the holders of the Debenture Bonds were probably creditors for liquidation purposes. (I-R. 183)

1949).[5] A summary of these factors as they apply to the present situation is as follows:[6]

(1) The Names Given to the Certificates Evidencing the Indebtedness. The Debenture Bonds in question were designated as Series A Four Percent Registered Debenture Bonds. (I-R. 15; II-R. 32)

(2) The Presence or Absence of a Maturity Date. Each Debenture Bond had a fixed maturity date of June 4, 1972. (I-R. 15, 216; II-R. 32)

(3) The Source of the Payments. Each Debenture Bond contained an unconditional promise to pay in all events, which was in no way dependent upon or related to the earnings

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[5] Wilbur Security Co. v. Commissioner, supra and O.H. Kruse Grain and Milling v. Commissioner, supra, each listed the eleven (11) criteria which are to be considered.

[6] In analyzing the evidence in this case, this Court should be mindful of the fact that appellee alone presented evidence establishing the existence of these criteria. The testimony of Messrs. Hayman and Hannam and the documents introduced by appellee were neither impeached nor controverted. Accordingly, even though Messrs. Hayman and Hannam were interested witnesses, their testimony may not be disregarded. See Chesapeake & Ohio Ry. Co. v. Martin, 283 U.S. 209, 215-220; Nicholas v. Davis, 204 F.2d 200 (10th Cir. 1953).

of appellee. (I-R. 15; II-R. 33, 83)

(4) The Right to Enforce the Payment of Principal and Interest. The Debenture Bonds provided that in the event of default in the payment of interest, the entire amount of the bond would become due and payable, which claim was enforceable in a court of law. (I-R. 15)

(5) Participation in Management. The Debenture Bonds did not provide for any voting rights or any participation by the bondholder in the management of appellee. (I-R. 15; II-R. 33-34)

(6) A Status Equal to or Inferior to that of Regular Corporate Creditors. The status of the bondholders was equal to that of regular corporate creditors since the bonds were enforceable "debt" under the provisions of local law, having been duly authorized for issuance by the California Corporation Commissioner. (I-R. 215; II-R. 183) Nor were the Debenture Bonds ever subordinated. (I-R. 217; II-R. 83) Appellant attempts to contest the finding of fact that there was never a subordination since the bondholders executed a continuing guaranty for a $40,000.00 line of bank credit for appellee. Appellant reasons that the effect of this guaranty was the same as subordination of the Debenture Bonds since if appellee had failed, the bondholders would have had to use funds which they received with respect to the Debenture Bonds to satisfy appellee's

obligations to the bank. (Br. 23, n. 11) Appellant cites no authority for this reasoning. There was absolutely no subordination of the Debenture Bonds to any of appellee's creditors including its bank. There were no restrictions on the repayment of the Debenture Bonds while any bank loans remained unpaid such as was the case in P.M. Finance v. Commissioner, 302 F.2d 786 (3rd Cir. 1962), a case relied upon by appellant at the trial. The obtaining of a continuing guaranty from the shareholders of small or closely held corporations is a normal banking practice, a fact which appellant's own expert witness, Mr. Jewell, testified to under cross-examination. (II-R. 129) Under appellant's logic there could rarely be Debenture Bonds for tax purposes in any closely held corporation which at any time borrowed from a bank.

(7) The Intent of the Parties. The record is replete with uncontroverted evidence as to the intent of appellee and the bondholders to create a debtor-creditor relationship. Messrs. Hayman and Driskel were unwilling to subject all of their investment in appellee to the permanent risk of appellee's business. (II-R. 79-80) Accordingly, they concluded that a portion of their total investment should be represented by debt instruments enabling them to share with other creditors in the event appellee encountered future financial difficulties.

Furthermore, Messrs. Hayman and Driskel desired to protect their respective heirs by assuring said heirs a fixed flow of income in the event of their untimely deaths. (II-R. 80) This guaranteed flow of income could only be obtained by debt instruments with fixed rates of interest payable in all events. Such intent of the parties is further evidenced by the fact that the Debenture Bonds were always clearly reflected on appellee's books, records and financial statements (I-R. 217; II-R. 88), even though such reflection had an adverse effect on appellee's credit rating. (II-R. 90-92) The intent in including the redemption payment feature was to protect the heirs by increasing the marketability of the bonds. (II-R. 83-85)

Appellant has chosen to ignore the intent of the parties. In Los Angeles Shipbuilding & Drydock Corp. v. United States, supra, this court stated at p. 227:

> "This Circuit [the Ninth] holds that the intention of the parties is a major factor in determining whether advances by stockholders to a corporation are loans or capital investments."

See also Albert W. Petersen, T.C. Memo 1965-145.

The only evidence in this case conclusively demonstrates that it was the unequivocal intention of the parties that a debtor-creditor relationship be

established. This manifest intent may not be cavalierly disregarded by appellant in its zeal to collect maximum tax revenues. As was stated by Judge Tuttle in Rowan v. United States, 219 F.2d 51 (5th Cir. 1955), at p. 54:

> "Recognizing fully that the Government is not bound in its tax collecting activities by the terminology used by taxpayers if such terminology is actually used to disguise something quite different, we nevertheless have seen no authority for the proposition that the stockholders of a corporation may not determine just how much of their funds they care to risk in the form of capital and how much, if any, they are willing to lend as a creditor. If they make such a determination and it is clear that such is their intent,. . .this does not entitle the Commissioner of Internal Revenue to re-write their balance sheet for them and show to be capital what was intended to be a loan."

Judge Tuttle added, at p. 55:

> ". . .the Court also recognizes that, entirely without reference to the incidence of taxes, stockholders of corporations have always been free to commit to corporate

operations such capital as they choose and to lend such additional amounts as they may elect to assist in the operation if that is their true intent, always thus reserving the right to share with other creditors a distribution of assets if the enterprise fails."[7]

(8) "Thin" or Adequate Capitalization. Appellant apparently does not contend that there was a "thin" incorporation, except that in an oblique manner an attempt is made to ignore the substantial good will which was transferred to appellee. (Br. 23) The District Court found that good will, in fact, existed and included (1) customer lists and accounts; (2) substantial unfilled orders; (3) the name "HASKEL ENGINEERING & SUPPLY CO."; and (4) "going concern value"

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[7] No undue significance should be attached to the fact that income tax considerations were evaluated in the formulation and consummation of appellee's business judgment decision to issue the Debenture Bonds. Indeed, all well considered modern business decisions today involve and require such analysis. See for example, Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956); Charles D. Vantress, T. C. Memo. 1964-123, and cases cited therein.

as represented by an established integrated, profitable business structure with organized plant facilities, equipment and experienced personnel. (I-R. 214-215) These findings are clearly supported by the evidence of Mr. Hannam (II-R. 13-15, 57-65), and Mr. Hayman (II-R. 81-82). There was even substantial evidence that using one of the government's own formulae, (A.R.M. 34), good will did exist in an amount substantially in excess of $14,000.00. (II-R. 152-154) The fact that good will did not appear on the balance sheet of the predecessor partnership does not mean that it did not exist. It only means that the good will had not been purchased by the predecessor partnership and thus, did not have a cost basis. Thus, even if this conservative amount of good will and the book value of the other assets transferred is used, appellee's "debt-equity ratio" was approximately three to one which is comfortably within permissible limitations.[8] The value of good will is properly includible in determining whether the corporation was inadequately or "thinly" capitalized. Miller's Estate v. Commissioner, 239 F.2d 729 (9th Cir. 1956).

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[8] See Earle v. W. J. Jones & Son, Inc., supra, and cases collected in Caplin, The Caloric Count of the Thin Incorporation, N.Y.U. 17th Inst. on Fed. Tax, 771, 782-783, 792-795 (1959).

(9) Identity of Interest Between Creditor and Stockholder. As is normal in the case of issuing debt securities to shareholders of a close corporation, the Debenture Bonds were issued to Messrs. Hayman and Driskel in the same proportions that they held capital stock in appellee.

(10) Payment of Interest. Payment of interest on the Debenture Bonds was to be made in all events and all interest payments were always timely made and none were ever omitted during the four year period that the indebtedness was outstanding. (I-R. 216-217, II-R. 83) Thus, in design and in practice, interest was in no way contingent upon appellee's earnings.

(11) The Ability of the Corporation to Obtain Loans from Outside Lending Institutions. It appears to be upon this single criterion that appellant argues for the proposition that the Debenture Bonds should not be considered as evidences of indebtedness. Appellant sets forth a lengthy philosophical discussion attacking the marketability of the Debenture Bonds, (Br. 24-28) and that hypothetical outside lenders could not have been procured under the terms of the Debenture Bonds as issued since the interest rate of four (4%) percent was too low and the Debenture Bonds did not provide adequate security for the bondholder.

Appellee submits that the determination of the

four (4%) percent per annum interest rate by its Board of Directors was reasonable and did cause the Debenture Bonds to be marketable. There can be no question from the testimony that the intent was to arrive at a reasonable rate of interest. (II-R. 34-35) This rate of interest was higher than that being paid by savings and loan associations, although appellant has implied that such was not the case.[9]

It should also be noted that appellee was not free to provide for an unlimited rate of interest, lest its Debenture Bonds be likewise attacked as constituting

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[9] The interest rate being paid by savings and loan associations in California in 1952 was three (3%) percent. See 59th ANNUAL REPORT OF BUILDING & LOAN COMMISSIONER, STATE OF CALIFORNIA 18 (1952). Also, the maximum interest rate for long-term commercial deposits in savings accounts of Federal Reserve Member Banks in 1953 was two and one-half (2-1/2%) percent, and the average prevailing rate of interest paid on United States government securities at that time ranged from 1.72% to 2.13%. See FEDERAL RESERVE BULLETIN, December 1953, at 1336, 1357.

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equity investments because of an excessive interest rate.[10]

As to security provisions, the Debenture Bonds did provide for acceleration upon default which was enforceable in a court of law. As for the absence of liens on assets, the reliance on the general credit of the corporation is precisely the distinctive feature of a debenture bond. Appellee submits that the absence of the other security provisions listed by appellant did not deprive these Debenture Bonds of marketability.

In summary, appellant's entire attack on the Debenture Bonds appears to be based on a claimed lack of compliance with the "marketability" criterian. Appellee, on the other hand, unequivocally demonstrated that it strictly met no less than nine of the listed criteria and strongly

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[10] In Nassau Lens Co., Inc. v. Commissioner, supra, at p. 47, the court stated that:

> ". . .although the usual question relates to whether the debt is too risky, the Court may also consider whether the loan is not risky enough in the since that the interest or discount sought to be deducted is substantially higher than the going market rate for loans of the kind involved. . ..In such case, a court may well determine the distorted interest or discount rate is, in terms of substantial economic reality, a dividend."

urges that the "marketability" criteria was also met.[11]

If appellant's implicit argument were accepted, i.e., that if a security is not totally marketable, there is no debt, then closely held corporations would be

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[11] The entire thrust of appellant's argument on this point seems to be a combination of governmental second-guessing of business decisions made over fifteen years earlier together with some mystical claim of tax avoidance or sham which is based upon the premise that the appellee corporation was merely an alter ego of its stockholders. This similar approach by the Commissioner drew this comment from the Tax Court recently in Estate of Powel Crosley, Jr., 47 T.C. ___, No. 29:

> "The original deficiency in this case is in excess of $1,000,000. Respondent is after big game, but his weapons, sections 2402, 2036 and 2038, are blunt against the impervious hide of the decedent's estate planning. Arguments that there was an elaborate and deliberately confused tax-avoidance scheme concocted by masterminds, are just not supported by the evidence before us. Respondent's quarry is not to be bagged by mere characterizations and repetitive but unsupported charges of 'sham' and 'tax avoidance scheme'." (Emphasis added)

precluded from issuing debt securities.[12] Appellant has cited no authority for such a proposition. Indeed, the authorities all pursue a weighting of the various cited criteria at arriving at their determinations.

Appellee submits that this weighting process if clearly illustrated in each of the cases which appellant has cited. (Br. 27-28) For instance, in Nassau Lens Co., Inc. v. Commissioner, supra, the court clearly considered the marketability criteria to be only another factor in its ultimate determination.[13]

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[12] In Taft v. Commissioner, supra, payments on an unsecured, non-interest bearing promissory note over a five-year period were held to be payments on a bona fide indebtedness.

[13] At p. 47 the court stated:

> "The starting point is, of course, whether there is an intent to repay, for in the absence of that, no debt can be said to exist. . ..Other factors to be considered relate to the extent to which the debentures bear a substantial risk of the enterprise and, like risk capital, are tied up indefinitely with the success of the venture. . ..Relevant considerations are whether the debt instruments are subordinate

In Wilbur Security Co. Commissioner, supra, the court found that the taxpayer had conceivably met only two of the eleven criteria.[14] In Affiliated Research, Inc. v. United States, 351 F.2d 646 (Ct. Cl. 1965), the court found that not only would no outsider have loaned money on the basis of the notes but that the debt-equity ratio of the corporation ranged from 72-1 to 131-1, and that there had been an outright subordination. In O.H. Kruse Grain and Milling v. Commissioner, supra, the court found that the taxpayer had clearly met only one of the eleven criteria - to wit, he had used the form of a promissory note.

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to those held by outsiders or whether they specify a relatively fixed date upon which the creditor may demand a definite sum regardless of the profits earned. . ..The Tax Court should also give consideration to the debt-equity ratio and the question of whether outside investors would have made similar advances."

[14] At p. 662, n.1, the court stated: "There was in fact no fixed maturity date; so called "interest" payments depended upon the taxpayer's earnings; the determination of whether interest would be paid. . .was solely in the discretion of the taxpayer's board

It is obvious that none of the cases relied upon by the appellant have even the remotest similarity to these proceedings. While appellee is not attempting merely to quantify these criteria, appellee does contend that when so many of them have been fully met (especially those of "intent" and "adequate capitalization") appellee should prevail on this issue.

B. The Redemption Premium Payments Were Deductible.

Appellant asserts for the first time during any of these proceedings and without stating any pertinent authority therefor, that even if the Debenture Bonds are held to be "indebtedness" within the meaning of the Internal Revenue Code, the redemption premium payments are nevertheless not deductible. (Br. 28)

Section 162(a) of the Internal Revenue Code provides generally that all ordinary and necessary

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of directors; the notes were not paid on due dates; there was no attempt to enforce payment . . .; and outsiders would not have made advances under like circumstances, to wit, for an indefinite length of time, in effect subject to the risks of the business, and the return thereon being exclusively within the discretion of the taxpayer's board of directors."

business expenses paid or incurred by a taxpayer are deductible. Treas. Reg. §1.61-12(c) specifically provides:

> "(1) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase over the issuing price or face value is a deductible expense for the taxable year." (Emphasis added)

For cases allowing bond redemption premiums to be deductible as business expense, see Roberts & Porter, Inc. v. Commissioner, 307 F.2d 745 (7th Cir. 1962); San Joaquin Light & Power Corp. v. McLaughlin, 65 F.2d 677 (9th Cir. 1933). Accordingly, there can be little question but that the premiums paid by appellee on the redemption of its Debenture Bonds were properly deductible under section 162 of the Internal Revenue Code.

Moreover, it is submitted that the premium payments were likewise deductible as interest on indebtedness under section 163 of the Internal Revenue Code. In Rev. Rul. 57-198, 1957-1 C.B. 94, the Internal Revenue Service expressly conceded that:

> ". . .penalty payments made by a taxpayer to his mortgagee for the privilege of prepaying his mortgage indebtedness are

deductible as interest under the provisions of section 163. . .."

The applicability of this revenue ruling to the bond redemption premium payments made by appellee is manifest.

There was no evidence as appellant next contends that appellee redeemed the debentures "merely because corporate earnings were high". Rather, the purpose for the early redemption according to the irrefuted testimony of Messrs. Hayman and Hannam was due to (1) a cash position which the Board of Directors considered to be in excess of immediate working capital requirements; (2) the elimination of the Debenture Bonds from the balance sheet as long-term debt;[15] (3) a saving of half of the remaining interest that would have otherwise been paid; and (4) taking a tax deduction on the payments at a time when the profits were higher than anticipated. (II-R. 36-37, 92) The existence of any of these reasons would qualify the payments as an ordinary and necessary business expense, appellant's unsupported assertions to the contrary notwithstanding.

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[15] As discussed by Mr. Hayman (II-R. 88-92) appellee was obviously disadvantaged in having its Debenture Bonds reflected on its financial statements to its customers and on Dun & Bradstreet credit reports, as long-term debt. Exhibit 29.

Appellant also contends that failure of the District Court's Memorandum Opinion (I-R. 196) to state that the redemption premiums were reasonable in amount establishes that the court "allowed the claimed deductions to taxpayer without considering the question of whether the 'redemption premium' payments qualified for deductions." (Br. 28, n.17) An examination of the entire record clearly demonstrates that this issue was never previously raised by appellant. Accordingly, the District Court was not required to make a finding on a matter which was not an issue.

It is well settled that neither party (including the government) may raise for the first time on appeal an issue not previously raised in the Trial Court. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935); Doric Co. v. Commissioner, 341 F.2d 967 (9th Cir. 1965); Commissioner v. Belridge Oil Co., 297 F.2d 345 (9th Cir. 1959). It was not until appellant filed its brief in this case that the issue was raised that the bond redemption premiums did not qualify "as a business expense under section 162(a) of the 1954 Code, supra, let alone as interest." (Br. 29) An examination of the statutory notice of deficiency (Exhibit 4), the pre-trial conference order (I-R. 131, 132) and all of the arguments made by government counsel during the trial establishes this. As was pointed out in

General Utilities & Operating Co. v. Helvering, supra, a taxpayer is entitled to know with fair certainty the basis of the government's claims against him. Appellant should not be permitted to raise this new issue for the first time on appeal.

C. The District Court Applied The Correct Standards.

Appellant urges with questionable candor to this Court that the District Court applied an erroneous standard, claiming that the District Court erroneously limited its inquiry to whether the Debenture Bonds were enforceable as debt under state law and to whether the issuance constituted a fraud against the United States. (Br. 21) Appellant has conveniently ignored the cogent explanation by the District Court on the hearing of appellant's Motion for Court to Reconsider Memorandum Opinion. (Tr. 1-8) After appellant there complained of undue emphasis having been placed on the word "legitimate", the court replied:

> "When I said legitimate I didn't mean that it was legal as opposed to illegal, I meant that it was what it purports to be. They took some security notes instead of stock and they had a right to do that. . .there was no subterfuge. . .these taxpayers are

entitled to operate their business as they see fit within certain limitations, true, but I don't know any other word I could use but 'legitimate'." (Tr. 5-6)

This statement by the District Court supplements and clarifies its comments at the trial which made it clear that use of the term "legitimate" meant only that shareholders have a right to select a proper alternative which produces less tax consequences. (II-R. 140-141) That the District Court clearly recognized its responsibilities and the standard to be applied is its further statement that "the fact that they are called debenture bonds. . .isn't persuasive with me unless they are proven to be debenture bonds." (II-R. 19)

The District Court had properly presented to it the question of whether the Debenture Bonds were what they purported to be -- evidence of indebtedness for purposes of federal taxation. It heard evidence on all of the criteria discussed herein, and on the basis of such evidence, correctly determined this question.

II

The District Court Correctly Determined That Appellee Had Properly Computed And Claimed As Deductions Its Annual Additions To Its Reserve For Bad Debts.

Appellee made additions to its bad debt reserve

for the taxable years 1958 and 1959 in the amounts of $3,313.80 and $1,800.00, respectively. The Commissioner disallowed the entire addition for the taxable year 1958 and disallowed $882.75 of the addition for the taxable year 1959. The District Court properly sustained appellee's deductions taken for the addition in each year.

Section 166(c) of the Internal Revenue Code of 1954, as amended, allows a deduction for either debts which became worthless during the year or (in the discretion of the Secretary or his delegate) for a reasonable addition to a reserve for bad debts. Treas. Reg. §1.166-4(b) states that such a reasonable addition to a bad debt reserve shall be determined in the light of the facts existing at the close of the taxable year. The reasonableness of the addition will vary between classes of business and with conditions of business prosperity and will depend primarily upon the total amount of debts outstanding at the close of the taxable year and the total amount of the existing reserve.

From its inception, appellee has employed the reserve method of accounting for bad debts. (I-R. 217-218) Appellee's accounts receivable had steadily risen from approximately $32,000.00 in its taxable year 1954 to $321,000.00 by the end of taxable year 1959. (I-R. 126) At the end of taxable year 1958, appellee had a balance in

its reserve for bad debts of $3,426.51 before the adjustment required to the reserve for that year. Appellee's officers and directors determined that $3,313.80 was a reasonable addition to the reserve for that year, bringing the reserve balance to $6,740.31 (approximately 2.8% of its then outstanding accounts receivable). (I-R. 126) At the end of taxable year 1959, appellee had a balance in its reserve for bad debts of $5,392.34 before the adjustment required to the reserve for that year. Appellee's officers and directors determined that $1,800.00 was a reasonable addition to the reserve for that year, bringing the reserve balance to $7,192.34 (approximately 2.2% of its then outstanding accounts receivable). (I-R. 126)

The Commissioner made its determination of reasonable additions to the reserve for bad debts for 1958 solely on the basis of the ratio of the total uncollectible accounts charged to the reserve for the years 1954 through 1958 (1.2116% of total accounts receivable for that period) and for 1959 solely on the ratio of the total uncollectible accounts charged to the reserve for the taxable years 1954 through 1959 (.93219% of accounts receivable for that period) (I-R. 126-127)[16]

[16]Note that in either case, the determinations by appellee and appellant as to reasonable additions to the reserve represent an insignificant percentage of appellee's total accounts receivable. Appellant's formula approach is

Appellee carried its burden of proof of showing that the Commissioner's determination was erroneous. Appellee's burden was to prove that the Commissioner abused his discretion, as noted in the cases cited by appellant. (Br. 14-15) However, appellee does not agree, nor does appellant cite any authority, that appellee must prove that the Commissioner's determination was "arbitrary". (Br. 18) Appellee submits that the Commissioner's determination was inaccurate and incomplete. It consisted of a simple mathematical calculation based solely upon past experience of losses. Such a formula approach is merely the starting point of a reasonable determination and is to be supplemented by other facts and circumstances bearing upon reasonableness. This Court has recognized that such reliance on past history alone is merely a starting point in the determination of reasonable additions where other factors are extant. In Calavo, Inc. v. Commissioner, 304 F.2d 650, (9th Cir. 1962), it was stated at p. 654:

> "Since the reserve normally is dealing with unknown factors bearing upon unidentifiable accounts, its reasonable extent is ordinarily calculated by resort to past experience with such accounts in the composite. But the fact that experience is

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even more unreasonable in view of the fact that the "past" history" involves a period during which accounts receivable increased 1000%.

the guide in dealing with unknown factors and unidentifiable accounts should not require us to reject the more accurate guidance of known factors bearing upon identifiable accounts when such information is available. The extent of a reasonable reserve should depend upon an adjustment between circumstances and experience.

"It is in the making of this adjustment that the discretion of the Commissioner operates in cases such as this. The question upon review is whether the result amounts to an abuse of discretion." (Emphasis added)

The unrebutted testimony of Messrs. Hannam and Hayman established that at the end of each year account receivable cards were pulled, listed and segregated by age; that a complete, individual review of all accounts receivable were then made by the accountant with the credit manager and in most instances by the appropriate officers of appellee; that the identical practice was used each year; that smaller accounts were being added in each year in question, thus increasing the general probability that increased losses would be incurred; and that based upon the individual review of the segregated, aged accounts, a reasonable addition to the reserve for bad debts based upon both past history and future probability of anticipated losses was arrived at. (II-R. 37-39, 93-96) This extensive method of arriving at annual

reasonable additions to the reserve for bad debts were found as a fact by the District Court to be in accordance with sound business judgment and accepted accounting practices. (I-R. 218) Appellant submitted absolutely no evidence to rebut the fact that this thorough, sound and systematic method of arriving at the additions to the reserve had been followed, or to rebut the fact of appellee's changing business conditions. Appellant merely states that the testimony submitted by appellee was "unsupported" and "self-serving".[17] (Br. 18) Appellee urges that employment of sound business judgment and the use of accepted accounting practices is considerable "support" for a decision to make an indicated addition to a reserve for bad debts.

Appellant contends that appellee has a "heavy" burden of proof and sets forth a partial quotation from Art Metal Const. Co. v. United States, 17 F.Supp. 854 (Ct.Cl. 1937) (Br. 15-16) to the effect that the Commissioner's determination that an addition was not reasonable would not be lightly set aside. However, it is important to see the full context of the quotation. In the same paragraph from which appellant quotes, at p.863, the Court went on to state the following:

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[17] For a discussion of the weight to be given to the testimony of Messrs. Hayman and Hannam, see p. 16, supra, footnote 6.

". . .the total amount charged off by plaintiff from 1921 to 1927, inclusive, amounted to. . .an average of $7,769.71 a year. . ..The balance in the reserve as fixed by plaintiff at December 31, 1927, was $177,114.51, an amount more than three times the total charge off from 1921 to 1927, inclusive. When, therefore, the Commissioner allowed an addition for 1927 of $11,680.38 and showed a balance in the reserve at December 31, 1927, of $84,171.28, a showing of unusual circumstances would be necessary to require a conclusion that the Commissioner had abused his discretion. . .."[18]

Finally, appellant states that the District Court erroneously placed the burden of proof on appellant and required appellant to show that appellee had abused its discretion. (Br. 19) This statement is wholly without support. The District Court made a finding of fact that in determining the amounts of annual additions to

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[18] A comparison with the almost de minimus figures and percentage differentials involved in the instant controversy shows that the facts of the Art Metal Const. Co., supra, case are not even remotely comparable.

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its reserve for bad debts, appellee's accounts receivable were periodically reviewed and aged with a view toward determining reasonably anticipated losses; that those determinations were made in accordance with sound business judgment and accepted accounting standards and fully complied with the requirements of section 166(c); and that appellant's disallowances which were based solely upon appellee's past history of losses and without any regard to present facts and circumstances and anticipated future events were erroneous. (I-R. 218)

Thus, appellee carried its burden of proof that the Commissioner abused his discretion.

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CONCLUSION

The District Court properly considered the questions presented to it and determined that appellee's Debenture Bonds were, in fact, precisely what they purported to be and that appellee properly claimed deductions for interest and bond redemption premium payments. It also determined that appellee's annual additions to its bad debt reserves were reasonable in amount. The record in this case thoroughly supports these determinations which should be affirmed in all respects.

Respectfully submitted,

GOODSON AND HANNAM

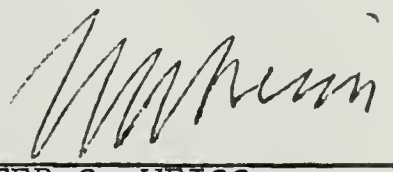
By: _____
WALTER S. WEISS

By: _____
RICHARD W. CRAIGO
Counsel for Appellee

CERTIFICATE

I certify that, in connection with the preparation of this Brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing Brief is in full compliance with those rules.

Dated: March 10, 1967.



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